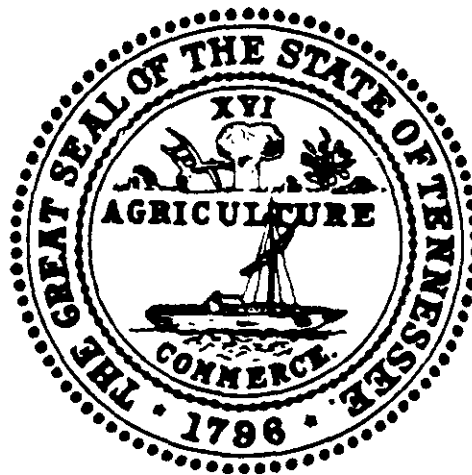


AUDIT REPORT

Department of the Treasury

For the Year Ended
June 30, 1998



STATE OF TENNESSEE
COMPTROLLER OF THE TREASURY

Department of Audit
Division of State Audit



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STATE OF TENNESSEE

William R. Snodgrass

COMPTROLLER OF THE TREASURY

Comptroller

STATE CAPITOL

NASHVILLE, TENNESSEE 37243-0264

PHONE (615) 741-2501

January 5, 1999

Members of the General Assembly
and
The Honorable Steve Adams, Treasurer
State Capitol
Nashville, Tennessee 37243

Ladies and Gentlemen:

Transmitted herewith is the financial and compliance audit of the Department of the Treasury for the year ended June 30, 1998.

Consideration of the internal control over financial reporting and tests of compliance disclosed certain deficiencies, which are detailed in the *Results of the Audit* section of this report. The department's management has responded to the audit findings; the responses are included following each finding. The Division of State Audit will follow up the audit to examine the application of the procedures instituted because of the audit findings.

Very truly yours,

A handwritten signature in dark ink, appearing to read "W. R. Snodgrass", is positioned above the typed name.

W. R. Snodgrass
Comptroller of the Treasury

WRS/ms
98/099

State of Tennessee

Audit Highlights

Comptroller of the Treasury

Division of State Audit

Financial and Compliance Audit
Department of the Treasury
For the Year Ended June 30, 1998

AUDIT OBJECTIVES

The objectives of the audit were to consider the Department of the Treasury's internal control over financial reporting to determine auditing procedures for the purpose of expressing an opinion on the general-purpose financial statements of the State of Tennessee and the financial statements of the Criminal Injuries Compensation Fund, the Claims Award Fund, the Chairs of Excellence Fund, the Flexible Benefits Plan, the Deferred Compensation Fund, the Baccalaureate Education System Trust, the State Pooled Investment Fund, and the Bond Refunding Fund; to determine compliance with laws, regulations, contracts, and grants; and to recommend appropriate actions to correct any deficiencies.

INTERNAL CONTROL FINDINGS

Amount of Public Deposits Not Confirmed

The Collateral Pool Board has not developed procedures for confirming the amount of public deposits in financial institutions participating in the pool (page 10).

Securities Confirmations Not Reconciled

The accounting division has not followed established control procedures for the verification of purchase transactions for the State Pooled Investment Fund. Confirmations received from the sellers have not been reconciled with security tickets (page 11).

Audit Report
Department of the Treasury
For the Year Ended June 30, 1998

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Department of the Treasury For the Year Ended June 30, 1998

INTRODUCTION

POST-AUDIT AUTHORITY

This is a report on the financial and compliance audit of the Department of the Treasury. The audit was conducted pursuant to Section 4-3-304, *Tennessee Code Annotated*, which authorizes the Department of Audit to "perform currently a post-audit of all accounts and other financial records of the state government, and of any department, institution, office, or agency thereof in accordance with generally accepted auditing standards and in accordance with such procedures as may be established by the comptroller."

Section 8-4-109, *Tennessee Code Annotated*, authorizes the Comptroller of the Treasury to audit any books and records of any governmental entity that handles public funds when the Comptroller considers an audit to be necessary or appropriate.

LEGISLATIVE HISTORY

The State Treasurer, a constitutional officer, is elected by a joint session of the General Assembly for a two-year term. Although no duties are prescribed by the constitution, the functions and duties of the office are assigned through various statutes. These functions and duties include maintaining accountability for and management of public funds and administering the Tennessee Consolidated Retirement System, the Local Government Investment Pool, the Uniform Disposition of Unclaimed Property Act, the Criminal Injuries Compensation Fund, the Chairs of Excellence Fund, the Baccalaureate Education System Trust, and the state's Deferred Compensation and Flexible Benefits Plans. The Treasurer also administers the settlement of claims against the state through the Tennessee Claims Commission and the Division of Claims Administration.

The Treasurer is required by statute to be a member of many boards and commissions, including the following:

Board of Equalization
Board of Trustees of the Tennessee Consolidated Retirement System
Funding Board
Public Records Commission
State Building Commission
State Insurance Committee

State School Bond Authority
Tennessee Competitive Export Corporation
Tennessee Housing Development Agency
Tennessee Local Development Authority
Tennessee Student Assistance Corporation

ORGANIZATION

The department is divided into nine major sections: Staff Services, Investments, Baccalaureate Education System Trust (BEST), Information Systems, Management Services, Tennessee Consolidated Retirement System (TCRS), Accounting, Unclaimed Property/Claims Administration, and Risk Management. The TCRS is audited and reported on separately.

The **Staff Services** section includes personnel administration, budgeting and fiscal control, research and development of special projects, internal audit, and legal services.

The **Investments** section invests the pension fund to maximize the return on investments and to protect the retirement system's assets. This section also invests the state's available cash in certificates of deposit in state depositories, prime commercial paper, prime bankers' acceptances, certain repurchase agreements, various U. S. Treasury and agency obligations, and certain obligations of the State of Tennessee.

The **BEST** section is responsible for the operation of the state's prepaid college tuition savings program.

The **Information Systems** section provides the department with data processing services, and **Management Services** provides centralized services, including physical facilities management, forms control and copying, safekeeping, remittance receiving, and operation of the Federal Reserve wire transfer facility used to send, receive, and transfer funds for the State Trust of Tennessee.

The **Accounting** section is responsible for maintaining detailed accounting records for all divisions of the department. This includes maintaining general ledger accounting and reporting for the Tennessee Consolidated Retirement System, the Chairs of Excellence Program, the Local Government Investment Pool, and the Cash Management Investment Program. The section is also responsible for reconciling approximately 200 bank accounts and maintaining the state's warrant reconciliation system (Account Reconciliation Package, or ARP).

The **Unclaimed Property/Claims Administration** section takes custody of abandoned property (bank accounts, insurance policies, etc.) and attempts to locate the rightful owners or heirs. The Division of Claims Administration administers the Workers' Compensation program for state employees and the Criminal Injuries Compensation Fund. The division reviews and

determines eligibility for payment from the Criminal Injuries Compensation Fund. Payments are made as funds become available.

The **Risk Management** section administers a variety of insurance programs for the state. These programs provide protection to the state against property damage, boiler explosion, and employee dishonesty.

An organization chart of the department is presented on the following page.

AUDIT SCOPE

The audit was limited to the period July 1, 1997, through June 30, 1998, and was conducted in accordance with generally accepted government auditing standards.

The Department of the Treasury is part of the primary government of the State of Tennessee and is accounted for in the general fund. The department administers the Tennessee Consolidated Retirement System, a pension trust fund; the Criminal Injuries Compensation Fund, a special revenue fund; the Claims Award Fund, an internal service fund; the Chairs of Excellence Fund, a nonexpendable trust fund; the Baccalaureate Education System Trust and the Flexible Benefits Plan, expendable trust funds; the State Pooled Investment Fund, an external investment pool (which includes the Local Government Investment Pool); and the Deferred Compensation Fund and Bond Refunding Fund, agency funds.

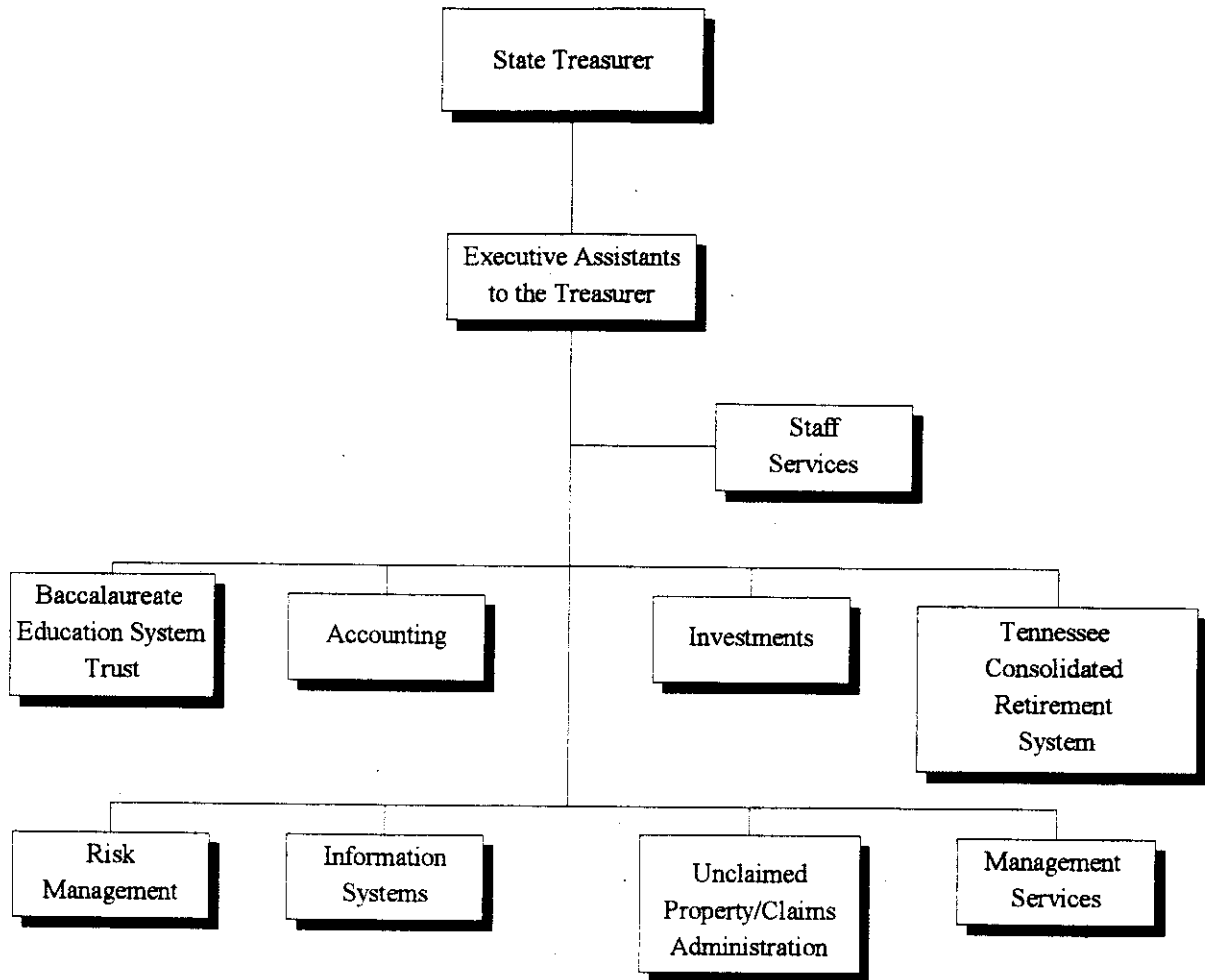
This audit included all of the above funds except for the Tennessee Consolidated Retirement System, which is reported on in a separate audit report. The following divisions and allotment codes within the State of Tennessee Accounting and Reporting System were covered by this audit:

State Treasurer's Office	309.01
Unclaimed Property	309.04
Criminal Injuries Compensation	313.03
Claims Award Fund	313.10

OBJECTIVES OF THE AUDIT

The objectives of the audit were

**DEPARTMENT OF THE TREASURY
ORGANIZATION CHART**



1. to consider the Department of the Treasury's internal control over financial reporting to determine auditing procedures for the purpose of expressing an opinion on the general-purpose financial statements of the State of Tennessee and the financial statements of the Criminal Injuries Compensation Fund, the Claims Award Fund, the Chairs of Excellence Fund, the Baccalaureate Education System Trust, the Flexible Benefits Plan, the Deferred Compensation Fund, the State Pooled Investment Fund, and the Bond Refunding Fund;
2. to determine compliance with laws, regulations, contracts, and grants; and
3. to recommend appropriate actions to correct any deficiencies.

Although this audit was not intended to serve as an organization-wide audit as described in the Single Audit Act, as amended by the Single Audit Act Amendments of 1996, and Office of Management and Budget (OMB) Circular A-133, "Audits of States, Local Governments, and Non-Profit Organizations," it included tests of compliance with applicable federal laws and regulations and consideration of internal control used in administering federal financial assistance programs. This audit is a segment of the organization-wide audit of the State of Tennessee, which is conducted in accordance with the Single Audit Act, as amended by the Single Audit Act Amendments of 1996, and OMB Circular A-133.

PRIOR AUDIT FINDING

Section 8-4-109, *Tennessee Code Annotated*, requires that each state department, agency, or institution report to the Comptroller of the Treasury the action taken to implement the recommendations in the prior audit report. The Department of the Treasury filed its report with the Department of Audit on July 23, 1998. A follow-up of the prior audit finding was conducted as part of the current audit. The current audit disclosed that the Department of the Treasury has not corrected the previous audit finding concerning controls over the Bank Collateral Pool. This finding is repeated in this report.

OBSERVATIONS AND COMMENTS

Tennessee Code Annotated, Section 4-21-901, requires each state governmental entity subject to the requirements of Title VI of the Civil Rights Act of 1964 to submit an annual Title VI compliance report and implementation plan to the Department of Audit by June 30, 1994, and

each June 30 thereafter. For the year ending June 30, 1998, the Department of the Treasury filed its compliance report and implementation plan on November 17, 1998.

Title VI of the Civil Rights Act of 1964 is a federal law. The act requires all state agencies receiving federal money to develop and implement plans to ensure that no person shall, on the ground of race, color, or national origin, be excluded from participation in, be denied the benefits of, or be subjected to discrimination under any program or activity receiving federal funds.

A summary of the dates state agencies filed their annual Title VI compliance reports and implementation plans is presented in the special report, *Submission of Title VI Implementation Plans*, issued annually by the Comptroller of the Treasury.

RESULTS OF THE AUDIT

AUDIT CONCLUSIONS

Internal Control

As part of the audit of the general-purpose financial statements of the State of Tennessee and the financial statements of the Criminal Injuries Compensation Fund, the Claims Award Fund, the Chairs of Excellence Fund, the Baccalaureate Education System Trust, the Flexible Benefits Plan, the Deferred Compensation Fund, the State Pooled Investment Fund, and the Bond Refunding Fund for the year ended June 30, 1998, we considered internal control over financial reporting to determine auditing procedures for the purpose of expressing an opinion on the state's financial statements as required by generally accepted government auditing standards. Reportable conditions, along with recommendations and management's responses, are detailed in the findings and recommendations. Consideration of internal control disclosed no material weaknesses.

Compliance

The results of our audit disclosed no instances of noncompliance that are required to be reported herein under *Government Auditing Standards*.



**STATE OF TENNESSEE
COMPTROLLER OF THE TREASURY
DEPARTMENT OF AUDIT
DIVISION OF STATE AUDIT
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NASHVILLE, TENNESSEE 37243-0264
PHONE (615) 741-3697
FAX (615) 532-2765**

**Report on Compliance and on Internal Control Over Financial Reporting
Based on an Audit of the Financial Statements
Performed in Accordance With *Government Auditing Standards***

December 29, 1998

The Honorable W. R. Snodgrass
Comptroller of the Treasury
State Capitol
Nashville, Tennessee 37243

Dear Mr. Snodgrass:

We have audited the general-purpose financial statements of the State of Tennessee and the financial statements of the Criminal Injuries Compensation Fund, the Claims Award Fund, the Chairs of Excellence Fund, the Baccalaureate Education System Trust, the *Flexible Benefits Plan*, the Deferred Compensation Fund, the State Pooled Investment Fund, and the Bond Refunding Fund, as of and for the year ended June 30, 1998, and have issued our reports thereon dated December 29, 1998. These reports were qualified because insufficient audit evidence exists to support the Department of the Treasury's disclosures with respect to the year 2000 issue. The Department of the Treasury and the funds it administers are part of the primary government of the State of Tennessee.

Except as discussed in the preceding paragraph, we conducted our audit in accordance with generally accepted government auditing standards.

Compliance

As part of obtaining reasonable assurance about whether the financial statements are free of material misstatement, we performed tests of the department's compliance with certain

provisions of laws, regulations, contracts, and grants, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and, accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance that are required to be reported herein under *Government Auditing Standards*.

We did, however, note certain other, less significant, instances of noncompliance that we have reported to the department's management in a separate letter.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the department's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control over financial reporting. However, we noted certain matters involving the internal control over financial reporting and its operation that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect the department's ability to record, process, summarize, and report financial data consistent with management's assertions in the financial statements.

The following reportable conditions were noted:

- Collateral Pool has no procedures for confirming the amount of public deposits reported
- Securities confirmations were not reconciled with security tickets

These conditions are described in the Findings and Recommendations section of this report.

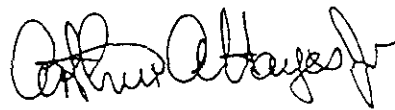
A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, we believe none of the reportable conditions described above are material weaknesses.

The Honorable W. R. Snodgrass
December 29, 1998
Page Three

We also noted other matters involving the internal control over financial reporting that we have reported to the department's management in a separate letter.

This report is intended for the information of the General Assembly of the State of Tennessee and management. However, this report is a matter of public record, and its distribution is not limited.

Sincerely,

A handwritten signature in black ink, appearing to read "Arthur A. Hayes, Jr.", with a stylized flourish at the end.

Arthur A. Hayes, Jr., CPA, Director
Division of State Audit

AAH/ms

FINDINGS AND RECOMMENDATIONS

1. Collateral Pool should confirm the amount of public deposits reported

Finding

The Collateral Pool was established to allow financial institutions and local governments statewide to participate in a collateral pool to provide an effective, efficient, low-risk system of collateralizing public funds. *Tennessee Code Annotated* prescribed the formation of the board to oversee the operations of the pool and attached the board, for administrative purposes, to the Department of the Treasury. The department began administering the pool in November 1995. Currently, the pool has approximately 42 participating financial institutions.

Previous audits indicated that the department was not confirming the amount of public funds deposited in participating pool financial institutions and, therefore, could not ensure that adequate collateral was pledged. Management concurred with the previous audit findings and stated that the Collateral Pool Board would develop new procedures for confirming the amount of public deposits in financial institutions participating in the pool. As of June 30, 1998, no such procedures had been developed.

If a collateral pool member financial institution becomes insolvent, the other pool members are assessed for any deficiency of collateral of the insolvent member. The amount of the assessment is designed to make the public depositors whole. As a result, the risk of loss to a collateral pool member is increased if the other pool members have not pledged collateral at the required target level.

Recommendation

The Collateral Pool Board should develop a written policy to govern how the amount of public funds deposited in participating pool financial institutions are confirmed. The department should develop procedures to implement the Board's policy. These procedures should then be promptly implemented by the department.

Management's Comment

Management concurs. On October 23, 1998 the Collateral Board adopted annual reporting requirements for institutions participating in the Collateral Pool to provide additional verifications that public deposits are properly identified and reported. The rules adopted by the Collateral Pool Board require that the annual report shall be filed no later than March 31 of each year. Financial institutions will be notified in January, 1999 of the reporting requirements. Each participating financial institution in the Collateral Pool will be required to file an annual report

relative to the verification of public deposits by March 31, 1999. The verification process adopted by the Collateral Pool Board provides that management of each financial institution shall certify that systems and controls are in place to ensure that public deposits are properly identified and reported. Furthermore, the Collateral Pool Board requires that the financial institution's independent internal or external auditors shall certify that they have examined and tested the institution's system and procedures that identify and report public deposits and found them effective, with any deficiencies noted in the audit report.

The newly adopted procedures by the Collateral Pool Board together with the many controls already adopted serve to protect public deposits. Other controls include strict admission requirements so that financially strong financial institutions participate in the pool, quarterly monitoring of the financial condition of participating financial institutions, pricing of collateral, monitoring sufficiency of collateral, monitoring acceptable collateral, monthly reconciliation of collateral with third party custodians, and obtaining additional information relative to certain financial data of participating financial institutions. Because of the quarterly monitoring of financial condition of participating financial institutions, the risk of default or insolvency of a collateral pool participant is considered highly unlikely.

2. Security confirmations were not reconciled with security tickets

Finding

Tennessee Code Annotated established the State Pooled Investment Fund (SPIF) and named the State Treasurer as the administrator of the fund. The Department of the Treasury is responsible for investing any money in the custody of any officer or officers of the state. The SPIF is authorized by the state statute to invest in funds in accordance with policy guidelines established by the Funding Board of the State of Tennessee. The current resolution of that board gives the State Treasurer the authority to invest in collateralized certificates of deposit in authorized state depositories, prime commercial paper, prime bankers' acceptances, certain repurchase agreements, various U.S. Treasury and Agency obligations, and obligations of the State of Tennessee.

The Department of the Treasury has not followed its own internal control procedures regarding security confirmations. The department's accounting procedures manual requires the following procedures:

- Accounting personnel are to match security confirmations received from sellers to related internal accounting documents (security tickets) for all investment transactions.
- Accounting personnel are to indicate receipt of the confirmations for certificates of deposit in the department's investment inventory system. The system then generates a list of certificates of deposit that were not matched to seller confirmations.

According to the department's written procedures, this listing should be printed at least twice a month and forwarded to the Division of Cash Management.

- Accounting personnel are to ensure that certain information on the security confirmations (i.e., maturity date, rate, issue date, etc.) agrees with the related information in the department's investment inventory system. If such information does not agree, accounting personnel are required to notify Cash Management to make the necessary corrections.
- Accounting personnel are to manually produce a list of other investments, such as commercial paper and repurchase agreements, which do not have corresponding security confirmations. This manual listing is to be forwarded to Cash Management and Internal Audit weekly.

Based on review of security confirmations and discussion with accounting personnel and management, accounting personnel have apparently not performed these required procedures for the majority of the fiscal year.

Although no discrepancies were noted during the audit, if security confirmations are not matched with security tickets and the department's investment inventory system, the department may not be aware of significant differences that could effect the financial statements. In addition, Cash Management would not be aware of missing security confirmations and the need to correct keying errors in the investment inventory system.

Recommendation

The Director of Accounting should ensure that security confirmations are compared with security tickets at reasonable intervals and that significant differences are investigated and reconciled. The Director of Accounting should also ensure that Cash Management and Internal Audit receive the information necessary to obtain security confirmations and correct keying errors.

Management's Comment

Management concurs. Current policy requires that broker confirmations of all investment transactions be reconciled to the internal security transaction tickets and any differences reported so that necessary research can take place. Accounting personnel have resumed such procedures. However, management notes that, with the exception of certificate of deposits (CD) transactions, reconciliation of broker confirmations is not the primary control over security transactions. Other primary controls in place to safeguard and account for non-CD assets include the simultaneous payment of funds upon delivery of the security, immediate return of securities not matching trade information, and reconciliation of internal investment inventory records to monthly custodian and Federal Reserve Bank security holding reports.